

Application of s401, Companies Act 2006 (Lecture A886 – 7.35 minutes)

Companies Act 2006, section 401 provides an exemption to an intermediate parent company from preparing consolidated financial statements (and obtaining an auditor's report on those consolidated financial statements) in certain circumstances.

This means that a UK intermediate parent with a non-UK parent is exempt from preparing consolidated financial statements, subject to certain conditions, including that the consolidated financial statements of the non-UK parent are prepared under:

- UK and Ireland GAAP or equivalent; or
- UK-adopted IFRS or equivalent.

The issue that has come to light is whether people are aware of how to apply these exemptions correctly. The consequence of any incorrect misinterpretation of the rules would mean that consolidated financial statements are not prepared, and an auditor's report is not obtained on those consolidated financial statements. In addition, audit firms must ensure that any exemption has been correctly claimed – especially when it comes to conclusions involving directors' judgement on the 'equivalence' test.

Conditions for s401 exemption

An intermediate parent based in the UK which has an overseas parent may be exempt from the requirement to prepare consolidated financial statements if it meets the conditions in section 401 of Companies Act 2006. These conditions include the company and all of its subsidiary undertakings being included in the consolidated financial statements of a larger group drawn up to the same date, or an earlier date in the same financial year. Those accounts and, where appropriate, the group's annual report, must be drawn up:

- in a manner that is equivalent to the requirements of Part 15 of Companies Act 2006 (section 401(2)(b)(ii));
- in accordance with UK-adopted international accounting standards (section 401(2)(b)(iii);
or
- in accordance with accounting standards that are *equivalent* to UK-adopted IFRS (section 401(2)(b)(iv)).

Whether the condition in section 401(2)(b)(iii) is met will generally be straightforward to determine because it is a matter of fact whether (or not) the group financial statements in which the UK intermediate parent is consolidated have been drawn up in accordance with UK-adopted IFRS. If they have not, the directors of the UK intermediate parent will need to consider whether the condition in section 401(2)(b)(ii) or (iv) is met instead.

The UK government has granted equivalence of certain accounting standards to UK-adopted IFRS. This will determine whether the condition in section 401(2)(b)(iv) is met. However, meeting the condition in section 401(2)(b)(ii) does not depend on equivalence having been

formally granted. Consequently, the directors may make their own assessment of equivalence in determining whether the company qualifies for the exemption, following the principles in section 401 of Companies Act 2006 and FRS 100.

In revising the equivalence guidance in November 2022, the FRC took the decision to include less prescriptive guidance and allow the directors to make their own assessment of equivalence when considering section 401(2)(b)(ii) issues. This is because different jurisdictions have different legal requirements and these can change on a regular basis, hence a more professional judgement approach was deemed necessary.

Important point

This will potentially be a very important point for auditors to consider in terms of whether the directors have arrived at the correct equivalence conclusion where they have taken advantage of a section 401 exemption.

There are some other important points where the s401 exemption is concerned as follows:

- a) exemption from preparing group accounts is conditional on the company (and all of its subsidiary undertakings) being included in consolidated accounts for a larger group drawn up to the same date; or to an earlier date in the same financial year, by a parent undertaking;
- b) those group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established;
- c) the company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts;
- d) the company must provide, in its individual accounts, the name of the parent undertaking which draws up group accounts, the address of the undertaking's registered office (whether in or outside the UK) and, if it is unincorporated, the address of its principal place of business; and
- e) the company must deliver copies of the group accounts and, where appropriate, the consolidated annual report together with the auditor's report on them.

One of the most common issues we note is a failure to comply with e) above where the group accounts are not delivered to the Registrar of Companies.

Assessing 'equivalence'

Both FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* provide certain exemptions from disclosures under a reduced disclosure framework. Those exemptions are, in some cases, subject to equivalent disclosures being provided in the consolidated financial statements of a group in

which the entity is consolidated. FRS 102 also permits an alternative measurement option for certain share-based payment transactions provided an equivalent basis is used.

Use of the exemptions requires a careful analysis of whether the framework (or specified elements of it) that are applied in practice is **equivalent** to another framework (or specified element of it). The Application Guidance in FRS 100 *Application of Financial Reporting Requirements* will need to be consulted in these cases.

An important point to emphasise where the equivalence test is concerned is that references to 'equivalence' to another financial reporting framework does not mean compliance with every detail of that framework. It is necessary to consider whether the *basic* requirements of that framework are met (e.g. the requirement to give a true and fair view, or present fairly, in all material respects).

The equivalence guidance in FRS 100 clarifies that a qualitative approach is more in keeping with the deregulatory nature of the exemption rather than a requirement to consider the detailed requirements on a checklist basis.

Equivalent GAAPs

The UK government has recognised the equivalence to UK-adopted IFRS of the following GAAPs, which includes those GAAPs previously recognised by the EC as equivalent to EU-adopted IFRS:

